# 13.04 Deferred Tax Assets

Rog Co. receives rental revenue in advance of $50 at the start of the year that is for the next 5 years. For book purposes our revenue is $50/5 = $10/year, as we are required to use the accrual method. For tax purposes all $50 would be recognized today as we are a cash basis taxpayer, so we have prepaid the tax due, creating a deferred tax asset (DTA). Assume the current tax rate is 20%, and the future rate is 30%.

**Book**

| | | | |
|---|---|---|---|
| **X1** | Cash | 50 | |
| | Rent revenue | | 10 |
| | Unearned revenue | | 40 |
| **X2** | Unearned revenue | 10 | |
| | Rent revenue | | 10 |

**Tax**

| | | |
|---|---|---|
| Cash | 50 | |
| Rent revenue | | 50 |
| Unearned revenue | 0 | |
| Rent revenue | | 0 |

If income in X1 was $150 before this $50 revenue and $200 in X2,

**X1**

$150

| Book | Tax | |
|---|---|---|
| 150 | 150 | |
| +10 | +50 | |
| 160 | 200 | × 20% = $40 current tax liability |

Difference is $40 which will reverse at $10 per year, if future tax rate is 30%, $40 × 30% = **$12 DTA**

**X2**

$200

| Book | Tax | |
|---|---|---|
| 200 | 200 | |
| +10 | +0 | |
| 210 | 200 | × 30% = $60 |

Difference is $10, so the difference starts to reverse out. We then measure the remaining asset of $30 (40 – 10) at the future tax rate of 30%, and that gives us a new **Target Asset of $9**. That means we need to reduce the DTA from 12 down to 9.

*Note: The cumulative difference is analyzed over time to determine the amount needed in the DTA account at year end.*

**Journal Entries**

| | | | | |
|---|---|---|---|---|
| X1 | Income tax expense | 28 | | (current 40/deferred 12) |
| | Deferred tax asset | 12 | | |
| | Current tax liability | | 40 | |

| | | | | |
|---|---|---|---|---|
| X2 | Income tax expense | 63 | | (current 60/deferred 3) |
| | Deferred tax asset | | 3 | (to get to target of $9) |
| | Current tax liability | | 60 | |

## Valuation Allowance

When a company has a **deferred tax asset,** it must determine if it is **more likely than not** (ie, 50% or more likelihood) that some or all of the asset will not be realized (eg, due to insufficient future taxable income). If that is the case, a DTA valuation allowance is established for the portion that is not expected to be realized. This is a contra-asset to the DTA, thus reducing it.

If, for example, we had a deferred tax asset of $12, but we only expect to use $8, that means it is more likely than not that $4 will not be realized. Therefore, a DTA valuation allowance must be established for $4. By recording this allowance, we are increasing our income tax expense by $4 from $28 to $32.

| | | |
|---|---|---|
| Income tax expense | 32 | |
| Deferred tax asset | 12 | |
| Current tax liability | | 40 |
| DTA valuation allowance | | 4 |

## Uncertain Tax Positions

FASB defines a **tax position** as a position previously taken on a tax return (or expected to be taken in the future) that is reflected in determining current or deferred income tax assets and liabilities. An entity may have **uncertain tax positions** (UTPs) related to deductions, credits, or income that have not yet been resolved with the tax authorities. These UTPs must be reviewed to determine if potential accruals and disclosure are required in the F/S.

The **tax benefit** from a UTP may be recognized or unrecognized on the F/S.

- ASC 740 requires that a tax benefit resulting from a UTP can be **recognized** only if there is a **more-likely-than-not** (greater than 50%) **chance** the tax position will be sustained. The tax

benefit recognized is limited to the estimated outcome with the largest dollar amount associated with a *greater than 50% cumulative probability* of occurring.

- An **unrecognized** tax benefit is reported as a **liability** representing the potential income taxes a company may have to pay in the future due to UTPs. The journal entry would be:

| | | |
|---|---|---|
| Income tax expense | XX | |
| Unrecognized tax benefit liability* | | XX |

**The unrecognized tax benefit can be realized when the tax position is settled or can no longer be challenged.*

Assume an entity took a tax position on its current year tax return resulting in a $20,000 deferred tax benefit. Based on technical merits, it is determined that the position has a greater than 50% chance of being sustained. The amounts and possible outcomes of the position being allowed are as follows:

| Possible estimated outcome | Individual probability of occurrence | Cumulative probability of occurrence |
|---|---|---|
| $20,000 | 25% | 25% |
| 15,000 | 35% | 60% |
| 10,000 | 30% | 90% |
| 5,000 | 10% | 100% |
| | 100% | |

Since the entity has determined the more-likely-than-not threshold has been met, the tax benefit qualifies for recognition. Determining the amount to be recorded requires an analysis of the cumulative probability of occurrence. Although three of the possible outcomes each have a cumulative probability of occurring that is greater than 50%, the entity records the outcome with the largest dollar amount (not percentage) as the tax benefit (ie, $15,000).